HARVARD BUSINESS PUBLISHING

Finance Simulation: M&A in Wine Country
Terminology Primer

Reservation Price: If you are a *bidder*, the highest price you would be willing to pay to acquire a target company is called your "reservation price". It also is sometimes called a "walkaway price." To calculate a reservation price you need to consider all available information about the target, your own company, and possibly other bidders and targets. Using all available information, and assuming the acquisition is completed, estimate the value of the target. If you pay more than this value the NPV of the deal will be negative; if you pay less it is positive. In this sense, the reservation price is the "zero-NPV," or breakeven price.

Conversely, if you are the *target*, your reservation price is the lowest price at which you would be willing to be acquired.

Equity Consideration: Bel Vino and Starshine are considering a merger that would be consummated by an exchange of stock rather than a payment in cash. Such an exchange is called equity consideration, and such a transaction is called a stock deal (as compared to a cash deal). The following terms and considerations apply to stock deals.

- **Exchange ratio:** Target shareholders are offered stock rather than cash in a stock deal. The offer is expressed in terms of an exchange ratio: the number of shares of the bidder's stock offered in exchange for each share of the target. The Wine Country Simulation includes an Exchange Ratio Calculator to convert an offer price expressed in dollars to an equivalent exchange ratio based on each company's then-current stock price.
- **Announcement effect:** An offer to acquire a target is immediately disclosed to the stock market (all three Wine Country companies are public companies). Accordingly, stock prices probably will change; such a change is called an announcement effect. It is important partly because it changes the value of a proposed stock deal. Bidders should therefore consider the possible effect of a given proposal on stock prices before actually making a bid at a given exchange ratio.
- **Accretion & dilution:** In addition to being concerned about effects of a deal on stock prices, bidders often pay careful attention to the effect of a given deal on their earnings per share (EPS). This is particularly the case in stock deals because the bidder will issue new shares to acquire the target. If the recomputed EPS of the bidder rises because of the deal, the deal is said to be accretive. If EPS falls, the deal is said to be dilutive. The Wine Country Simulation includes an Accretion/Dilution Calculator to help players understand effects of proposed deals on bidders' EPS. Basically, the calculator computes the combined the net income of bidder and target and divides by the new total number of shares outstanding for the bidder, post-deal. This new EPS is compared to the bidder's old EPS to determine the accretion or dilution.